No. 95-2017

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In The

Supreme Court of the United States

October Term, 1995

SEYMOUR J. RYCKMAN, DAVID B. BLOOM, JERRY M. FRIEDMAN, JAMES NULL and THE STATE OF CALIFORNIA,

Petitioners,

vs.

ENVIRODYNE INDUSTRIES, INC.,

Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

RESPONDENT'S BRIEF IN OPPOSITION

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22 pp

QUESTION PRESENTED

Whether the general unsecured claims of former shareholders of Envirodyne Industries, Inc. ("Envirodyne"), which arose as a result of their failure to timely tender shares of common stock of Envirodyne in response to a tender offer commenced almost four years before Envirodyne's bankruptcy case, were properly subordinated to the claims of Envirodyne's general unsecured creditors based upon the individual characteristics of the former shareholders' claims and the specific facts and circumstances of Envirodyne's Chapter 11 case in accordance with the principles of equitable subordination embodied in section 510(c)(1) of the Bankruptcy Code, without requiring proof of wrongful conduct.

LIST OF PARTIES

Petitioners are Seymour J. Ryckman, David B. Bloom, Jerry M. Friedman, James Null and the State of California. In the Seventh Circuit, District Court and Bankruptcy Court, Jerry M. Friedman appeared in his capacity as custodian for Julie, Jennifer and Mark Friedman.

Respondent is Envirodyne Industries, Inc., a Delaware corporation. Envirodyne does not have a parent corporation, although Zapata Corporation is a significant shareholder. All of Envirodyne's subsidiaries are wholly owned subsidiaries.

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124 Cong. Rec. H11,095 (daily ed. Sept. 28, 1978), S 17,412 (daily ed. Oct. 6, 1978) *reprinted in* 1978 U.S. Code and Cong. Admin. News 5787 13

STATEMENT OF THE CASE

Petitioners' general unsecured claims against Envirodyne Industries, Inc. ("Envirodyne") were equitably subordinated to the claims of other general unsecured creditors in Envirodyne's Chapter 11 case because the claims asserted by Petitioners did not have any of the typical characteristics of debt. Petitioners had become creditors of Envirodyne by act of law when they failed to tender their shares in a short-form merger and failed to redeem their non-interest-bearing shares of Envirodyne during the nearly four years between the merger and the commencement of Envirodyne's Chapter 11 case. Unlike ordinary creditors, Petitioners had not loaned money to Envirodyne or provided it with goods or services. Unlike ordinary creditors, Petitioners did not have any guaranty that they would recover their investment. As investors in Envirodyne, Petitioners were in a position not only to share in Envirodyne's future earnings, but also to lose their investment if Envirodyne failed.

The Bankruptcy Court and the reviewing courts below found that Petitioners were essentially equity holders who never bothered to tender their shares of common stock. The courts held that Petitioners thus assumed the risk that Envirodyne would become insolvent at some future date of redemption, and, therefore, their claims should be equitably subordinated to those of ordinary unsecured creditors.

A. Background

In March 1989, Emerald Acquisition Corporation ("Emerald") was formed to acquire Envirodyne. (2a).[1] It is undisputed that a subsidiary of Emerald commenced an offer to purchase for cash all of the outstanding common stock of

1. Record citations are to the Appendices attached to the Petition for Writ of Certiorari.

Envirodyne, and, when the tender offer expired, purchased over 90% of all issued and outstanding shares. Petitioners failed to tender their shares of Envirodyne common stock in response to this tender offer. (13a).

On June 1, 1989, the Emerald subsidiary was merged with and into Envirodyne, which, as the surviving corporation, assumed all of its liabilities.[2] (12a). As of the effective date of this merger, all outstanding stock was automatically canceled, and the remaining stockholders no longer had any rights against Envirodyne other than to (a) redeem each share of Envirodyne stock for $40 *without* interest, or (b) dissent from the merger and obtain an appraisal of the shares in accordance with Delaware law. (2a). No shareholders dissented and obtained an appraisal, so all former shareholders of Envirodyne, including Petitioners, who failed to tender their shares, ceased to be equity holders of Envirodyne; they became general unsecured creditors of Envirodyne, by operation of Delaware law, entitled only to receive $40 per share without interest, upon demand. (2a). Petitioners have never given any reason why they failed to redeem their non-interest-bearing shares of former Envirodyne during the years between the merger and the commencement of Envirodyne's bankruptcy case. (13a).

On January 7, 1993, Envirodyne filed a voluntary petition for reorganization relief. (3a). On September 23, 1993, Envirodyne commenced an adversary proceeding to equitably subordinate the general unsecured claims held by 122 former shareholders of Envirodyne and by certain states that allegedly succeeded to the shares of their respective residents by virtue of

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2. Petitioners' claim that they never held any equity interest in Envirodyne elevates form over substance. (Petition for Writ of Certiorari at 2). Envirodyne, before the merger, and Envirodyne, after the merger, is the same corporation. Envirodyne merely underwent a short-form merger in accordance with Delaware General Corporation Law. (2a; Del. Code Ann. tit. 8 § 253 (1995)).

escheat laws. (3a). Petitioners were defendants in this adversary proceeding.

Under Envirodyne's plan of reorganization, the claims held by Envirodyne's general unsecured creditors were classified in one class, and Petitioners' claims were to be placed in a separate class if Envirodyne was successful in its attempt to subordinate Petitioners' claims. If Envirodyne was not successful in subordinating Petitioners' claims, then Petitioners' claims were to be treated the same as Envirodyne's other unsecured creditors.

Under the plan, Envirodyne's general unsecured creditors were entitled to a distribution of stock in reorganized Envirodyne.[3] (3a). If Petitioners' claims were subordinated, they only were entitled to a distribution of stock in reorganized Envirodyne if Envirodyne's other general unsecured creditors were paid in full.

Under the plan, as ultimately effectuated, Envirodyne's unsecured creditors were not paid in full. (3a). Their

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3. In Petitioners' statement of the case, they address Envirodyne's treatment of its secured lender and unsecured noteholders under the plan. (Petition for Writ of Certiorari at 3 and 9). Petitioners failed to raise any arguments with respect to the relative treatment of other creditors under the plan in the courts below and, therefore, have waived such arguments. *See Taylor v. Freeland & Kronz*, 503 U.S. 638, 645-46 (1992). Moreover, contrary to Petitioners' statement, Envirodyne did not pay all of its noteholders in full under the plan. Petitioners' analogy is incorrect. Envirodyne's lender and noteholders gave millions of dollars to Envirodyne in connection with the leveraged buyout. In contrast, Petitioners did absolutely nothing (for Envirodyne or themselves) for nearly four years and now argue that they should be treated equally with Envirodyne's secured lender, noteholders and unsecured creditors, who contributed to Envirodyne's ongoing operations after the merger.

distributions were worth approximately one-third of the allowed amount of their claims, instead of the approximately two-thirds originally projected, because of unexpected declines in the market value of reorganized Envirodyne stock. (3a). Given that Petitioners' claims were subordinated to Envirodyne's other general unsecured creditors, Petitioners did not receive any distribution under the plan. (3a). If Petitioners' claims had not been subordinated to Envirodyne's other general unsecured creditors and stock had been issued to Petitioners, just as stock was issued to Envirodyne's other general unsecured creditors, the market value of Envirodyne's stock would have been further diluted, causing a corresponding decline in the value of the distribution received by Envirodyne's general unsecured creditors under the plan. (10a).

B. Decisions Below

The three courts below held that Petitioners' claims should be equitably subordinated based upon the individual characteristics of their claims, which were more like equity than debt. Moreover, the three lower courts rejected Petitioners' argument that Envirodyne must prove wrongful conduct by Petitioners in order to subordinate their claims. (4a-5a; 19a-20a; 43a).

In the adversary proceeding pending before the Bankruptcy Court, Petitioner the State of California, joined by several other defendants, filed a motion for summary judgment. (29a). On Envirodyne's cross motion, the Bankruptcy Court entered summary judgment for Envirodyne and held that Petitioners' claims should be equitably subordinated to Envirodyne's other general unsecured creditors. (3a). The Court held that although Petitioners had valid general unsecured claims against Envirodyne, the facts and circumstances of the case required that

Petitioners' claims not be afforded the same priority as Envirodyne's other general unsecured creditors:

> [Petitioners] did not have any guarantees that they would recover their investment. They invested in Former Envirodyne with the hope of sharing in its future earnings but with the risk that they may lose their investment in the event that the company fails or performs poorly. Contrast this with the position of a general unsecured creditor. When a supplier extends credit, it does so with the reasonable expectation that it will be repaid in due course for the goods and services that it provided. Conversely, regardless of how the company performs, it does not expect to share in any profits. . . . The [Petitioners], although legally creditors, are in essence former equity holders who never took the time to tender their shares. Therefore, they are not entitled to the same distribution as an ordinary creditor in a plan of reorganization. The [Petitioners] never lent money to the corporation nor do they share any other characteristic of an ordinary creditor. They took certain risks when they purchased the stock of Former Envirodyne. That they became creditors of Envirodyne because they failed to timely tender their shares should not elevate their status to that of an ordinary creditor.

(49a-50a).

On appeal, the District Court affirmed:

> the [Petitioners] lost their equity interests and became creditors because they failed to redeem their shares of former Envirodyne in a timely fashion. . . . By delaying, the [Petitioners] assumed the risk that Envirodyne would be solvent when they sought payment. It would be inequitable to afford the [Petitioners] a priority equal to that of general creditors because they were dilatory in redeeming their equity interests.

(24a). Moreover, the District Court held that although Petitioners held valid, general unsecured claims created by operation of state law, this fact was not dispositive. "[H]aving a valid [general unsecured] claim under state law, even if created by state law, does not mean that a creditor must necessarily be treated equally with other general unsecured creditors under federal bankruptcy law." (26a).

On appeal, the Seventh Circuit affirmed and held that equitable subordination was appropriate based upon the specific facts and circumstances of this case:

> [Petitioners'] claims are, in substance, based on equity interests. When they invested in Former Envirodyne, they positioned themselves to benefit if the company performed well but they also accepted the risk that the company might perform poorly. Thus [Petitioners] accepted risks and benefits that Former Envirodyne's unsecured creditors did not, and as such their equity interests were legally subordinate to possible claims of unsecured creditors. Their current status as creditors arose from their failure to

> tender shares in the Emerald Sub short-form merger under Delaware law, as well as their failure to redeem their non-interest-bearing shares of Former Envirodyne in the three years subsequent to the merger. No amount of maneuvering can obscure the true nature of [Petitioners'] interests. . . . [Petitioners] became creditors because they failed to redeem their shares, and their dilatory behavior is inexplicable given that they merely held non-interest-bearing canceled shares of Former Envirodyne. Thus their claims in bankruptcy are far weaker than other general unsecured creditors.

(7a-8a).

SUMMARY OF ARGUMENT

Only rarely do courts equitably subordinate claims in bankruptcy cases. *Webster v. Barbara* (*In re Otis & Edwards, P.C.*), 115 B.R. 900, 914 (Bankr. E.D. Mich. 1990) ("We note that equitable subordination is a remedy that is rarely used by courts"). Even more rarely do they subordinate claims without requiring proof of creditor misconduct. Under these circumstances, Petitioners have not shown why it is important for the Court to decide a third equitable subordination case in less than a year. This is especially so since there is nothing in this case that is inconsistent with the Court's recent decisions in *Noland* and *CF & I*.

None of the reasons proffered by Petitioners for accepting certiorari withstand scrutiny. First, Petitioners suggest that the Court should grant certiorari in order to decide whether inequitable conduct is an absolute requirement for equitable

subordination, an issue left open by the Court in *Noland* and *CF & I*. It is premature to consider the issue at this time, however, because the lower courts have not sufficiently fleshed out the various circumstances in which it may be appropriate to subordinate a claim without proof of misconduct. Until the courts have that opportunity, this Court will not know the full ramifications of so limiting the application of equitable subordination. Leaving the issue to further development by the lower courts is appropriate at this time since equitable subordination is so rarely applied without the requirement of creditor misconduct.

Next, Petitioners claim that the Court should grant certiorari to restore uniformity among the circuits. As discussed more fully in Section IV, *infra,* there is no conflict among the Courts of Appeals. The fact that one bankruptcy court decision potentially conflicts with several Court of Appeals' decisions does not provide the type of conflict requiring review by this Court.

Finally, Petitioners argue that the Court should grant certiorari to provide predictability in the securities market by eliminating equitable subordination absent a finding of inequitable conduct. Such an argument is not as much an independent ground for granting certiorari as it is a rehash of a policy argument on the merits that was rejected below. In any event, no evidence suggests that securities transactions will be impeded by the Court's decision not to rule on the creditor misconduct issue in the *Noland* and *CF & I* cases.

REASONS FOR DENYING THE WRIT

I.

THE PETITION FOR CERTIORARI SHOULD BE DENIED BECAUSE THIS CASE IS IN HARMONY WITH THE COURT'S TWO RECENT DECISIONS REGARDING EQUITABLE SUBORDINATION.

This Court, in two recent decisions, held that a bankruptcy court may not equitably subordinate claims on a categorical basis in derogation of Congress' scheme of priorities. *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, __ S. Ct. __, 1996 WL 335333 at *8-9 (June 20, 1996); *United States v. Noland*, 116 S. Ct. 1524, 1527 (1996). In *Noland*, the Court held that a court could not equitably subordinate a postpetition, non-pecuniary tax penalty claim in derogation of "Congress's policy judgment that a postpetition tax penalty claim should receive the priority of an administrative expense" pursuant to section 507(a)(1) of the Bankruptcy Code. *Noland*, 116 S. Ct. at 1527-28. Similarly, in *CF & I*, the Court held that prepetition, noncompensatory tax penalty claims could not be equitably subordinated solely on the basis that they were penalty claims because such "categorical subordination" would be "at the same level of generality assumed by Congress in establishing relative priorities among creditors" under the Bankruptcy Code. *CF & I*, 1996 WL 335333 at *9.

The Court, however, in both decisions, expressly acknowledged that bankruptcy courts have the power under section 510(c) of the Bankruptcy Code to equitably subordinate individual creditor claims based upon the specific facts, circumstances and equities of a particular case so long as the "circumstances that prompt a court to order equitable subordination [do] not occur at the level of policy choice at

which Congress itself operated in drafting the Bankruptcy Code." *Noland*, 116 S. Ct. at 1528; *see also CF & I*, 1996 WL 335333 at *9. The Court declined to decide whether a bankruptcy court must always find creditor misconduct before a claim may be equitably subordinated. *Id.*

Unlike the lower courts in *Noland* and *CF & I*, in this case the Seventh Circuit, and the two other courts below, did not equitably subordinate Petitioners' claims based upon a categorical determination of the nature of the claims, but instead examined the specific characteristics of the claims. The Bankruptcy Court and the two reviewing courts examined all of the facts and circumstances surrounding Petitioners' claims and decided that Petitioners' individual claims should be subordinated because, among other things, they arose from former equity interests and retained many of the characteristics of equity, Petitioners' claims were non-interest-bearing claims and did not have the general characteristics of unsecured debt, and Petitioners were dilatory in failing to tender their shares in response to the 1989 tender offer and by failing to redeem their interests for nearly four years thereafter.

The lower courts' decisions were within the powers of the judiciary delegated by Congress when it enacted section 510(c). The decision in this case was consistent with standards for equitable subordination enunciated in *Noland* and *CF & I*. The Court need not grant certiorari in this case to avoid inconsistent decisions.

II.

THE PETITION FOR WRIT OF CERTIORARI SHOULD BE DENIED BECAUSE THE SEVENTH CIRCUIT'S DECISION IS CONSISTENT WITH PRIOR PRECEDENT AND NO PURPOSE WOULD BE SERVED BY GRANTING CERTIORARI.

Petitioners' assertion that the decision is a departure from prior case law is simply wrong. (Petition for Writ of Certiorari at 6-7). Prior to enactment of the 1978 Bankruptcy Code, courts regularly examined the circumstances surrounding claims related to or arising from equity interests to determine whether such claims should be equitably subordinated without proof of inequitable conduct. *See, e.g., McConnell v. Butler*, 402 F.2d 362 (9th Cir. 1968) (noteholders' claim subordinated to general unsecured debt); *Robinson v. Wangemann*, 75 F.2d 756 (5th Cir. 1935) (stock redemption debt subordinated to general unsecured debt based upon various facts, including the substance of the transaction that converted the equity to debt and the corporation's solvency at the time of payment); *Matthews Brothers v. Pullen*, 268 F. 827 (1st Cir. 1920) (claim held by stockholder who received cash and a note in exchange for stock was subordinated).

As this Court acknowledged in *Noland*, Congress adopted existing case law when it enacted section 510(c) of the Bankruptcy Code.[4] *Noland*, 116 S. Ct. at 1526. Since the

4. Because courts subordinated claims held by former equity holders without proof of misconduct prior to enactment of section 510(c), this case is distinguishable from the tax penalty cases recently reviewed by this Court. Courts did *not* regularly subordinate tax penalty claims prior to the enactment of section 510(c) and, therefore, Congress did not adopt such cases when it enacted section 510(c). *See, e.g., Midlantic National Bank v. New Jersey Department of Environmental Protection*, 474 U.S. 494, 500 (1968); *Burden v. United States*, 917 F.2d 115, 117 (3d Cir. 1990).

enactment of section 510(c), courts have continued to subordinate claims arising from former equity interests on a case-by-case basis without requiring inequitable conduct consistent with precedent established prior to enactment of section 510(c). *See, e.g., Weisman v. Goss* (*In re The Hawaii Corp.*), 694 F.2d 179 (9th Cir. 1982) (notes issued by a corporation for the purchase of stock subordinated to the claims of general unsecured creditors); *Liebowitz v. Columbia Packing Co.*, 56 B.R. 222 (D. Mass. 1985), *aff'd*, 802 F.2d 439 (1st Cir. 1986); *SPC Plastics Corp. v. Griffith* (*In re Structurlite Plastics Corp.*), 193 B.R. 451 (Bankr. S.D. Ohio 1995); *Ferrari v. Family Mutual Savings Bank* (*In re New Era Packaging, Inc.*), 186 B.R. 329 (Bankr. D. Mass. 1995); *In re SPM Manufacturing Corp.*, 163 B.R. 411 (Bankr. D. Mass. 1994); *In re Dino & Artie's Automatic Transmission Co.*, 68 B.R. 264 (Bankr. S.D.N.Y. 1986).

Petitioners' assertion that bankruptcy courts have gone "far adrift" from prior precedent and now feel free to equitably subordinate claims based on "unfettered notions of fairness" is absurd. (Petition for Writ of Certiorari at 5). Instead, lower courts have generally developed the doctrine of equitable subordination consistent with prior precedent and rarely applied the doctrine without requiring creditor misconduct. *Walker v. Ferguson* (*In re Import & Mini Car Parts, Ltd., Inc.*), 136 B.R. 178, 181 (Bankr. N.D. Ind. 1991) ("equitable subordination is most frequently encountered in situations where the creditor is guilty of some type of misconduct . . ."). Moreover, with this Court's recent decisions further limiting the doctrine of equitable subordination, Petitioners' fear that courts will abuse the doctrine is unfounded.

III.

THE PETITION FOR CERTIORARI SHOULD BE DENIED BECAUSE JURISPRUDENCE STILL IS DEVELOPING THE DOCTRINE OF EQUITABLE SUBORDINATION PURSUANT TO CONGRESS' DIRECTIVE.

It would be premature for the Court to grant certiorari on the issue of whether inequitable conduct is required in every equitable subordination case. Congress intended that the principles of equitable subordination be developed by the courts. *See, e.g.*, 124 Cong. Rec. H11,095 (daily ed. Sept. 28, 1978), S17,412 (daily ed. Oct. 6, 1978), *reprinted in* 1978 U.S. Code and Cong. Admin. News 5787 ("It is intended that the term 'principles of equitable subordination' follow existing case law and leave to the courts development of this principle"); *see also Noland*, 116 S. Ct. at 1526. If the Court were to grant certiorari at this point, it may arrest the further development of the doctrine on the basis of a handful of unique factual situations and end the discourse expected by Congress. If it becomes necessary for the Court to consider this issue, it should do so only after more Courts of Appeals rule on what factual circumstances require equitable subordination without wrongful conduct. The Court then will have a more complete picture of the ramifications of limiting the doctrine of equitable subordination to situations involving misconduct.

IV.

THE PETITION FOR CERTIORARI SHOULD BE DENIED BECAUSE THERE IS NO CONFLICT AMONG THE CIRCUITS.

Contrary to Petitioners' assertions, there is no conflict among the circuits. Both prior to and subsequent to enactment of the Bankruptcy Code, courts required inequitable conduct in all cases except for those rare cases where the status of the claim called for equitable subordination. *See supra* pp. 11-12. For instance, in both the Fifth and Seventh Circuits, courts have required inequitable conduct in all cases except those in which the status of the claim made it susceptible to subordination. *Compare In re Envirodyne Industries, Inc.*, 79 F.3d 579 (7th Cir. 1996), and *Robinson v. Wangemann*, 75 F.2d 756 (5th Cir. 1935), *with Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990), and *Benjamin v. Diamond* (*In re Mobile Steel Co.*), 563 F.2d 692 (5th Cir. 1977). No circuit court, however, has held that misconduct is required in every case, or that misconduct is not required in cases where the status of the claim is not at issue.

In mistakenly arguing that no uniformity exists among the circuits, Petitioners rely only upon a single 1988 bankruptcy court decision from the Western District of Missouri. *See In re Stern-Slegman-Prins Co.*, 86 B.R. 994 (Bankr. W.D. Mo. 1988) (general unsecured claims relating to stock redemption debt could not be subordinated to other unsecured claims without proof of fraud or misconduct). A conflict between the Court of Appeals' decision in this case and a single bankruptcy court opinion does not demonstrate the degree of conflict among the circuits meriting review by this Court.

Petitioners' arguments that the Court should grant certiorari in order to provide predictability in the law for public investors and in order to provide predictability in the treatment of "similarly situated creditors" are equally unpersuasive. Since no disagreement among the circuits exists, it cannot truly be said that the law is unpredictable. Petitioners' real argument is that they do not believe bankruptcy courts should have any flexibility in applying equitable subordination. Petitioners are asking this Court to eliminate the flexibility that Congress granted to the bankruptcy courts when it adopted section 510(c) and that is inherent in a court's exercise of its equitable powers. Petitioners' policy arguments were rejected by Congress when it enacted section 510(c), and by the courts below when they overruled Petitioners' arguments. These arguments on the merits do not justify granting certiorari.

CONCLUSION

For the reasons stated, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

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